

## **Zeti Akhtar Aziz: Towards gaining global growth potential of Islamic finance**

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Seminar on Islamic Finance "Towards Gaining Global Growth Potential of Islamic Finance", Hong Kong Monetary Authority, Hong Kong, 15 January 2008.

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It is my honour and great pleasure to be in Hong Kong today to speak at this seminar on Islamic Finance jointly organised by the Hong Kong Monetary Authority and the Islamic Financial Services Board. Islamic finance is now at the threshold of a new dimension in which, it has now an increased potential to strengthen international financial linkages between nations. And in so doing, it would contribute towards a more optimum allocation of financial resources across borders. Hong Kong, with its sophisticated financial infrastructure and high level of expertise in the financial sector, has strong potential to be an important linkage and an engaging partner in the international Islamic financial activity.

It is exactly six years ago that we were here in Hong Kong as our first destination, to promote the world's first sovereign sukuk issuance. The overwhelming response we received in Hong Kong provided the momentum effect that resulted in the successful issuance of the pioneering USD600 million Malaysian sovereign sukuk. It was more than two times over subscribed with one-third of the investors from this region. Six years hence, the Islamic financial landscape has been dramatically transformed into a vibrant, dynamic and competitive global intermediation mechanism that is supported by more than 300 Islamic financial institutions in more than 75 countries. It also has become among the fastest growing segments in the financial services industry.

In the early phase of its development, Islamic finance was essentially domestic centric, focussing on retail financing, trade financing and the financing of other commercial business activities. Two recent developments have however, influenced the subsequent direction of the development of Islamic finance. Firstly, the drive to diversify the domestic financial infrastructure so as to avoid the over dependence on the banking sector and secondly, the trend towards greater liberalisation of the financial system. These two trends have spurred the development of the Islamic financial markets and its greater integration into the international financial system, thereby raising the international dimension of Islamic finance.

This more dynamic environment, has fostered the generation of a wide spectrum of Islamic financial instruments that has ranged from instruments to manage liquidity to structures for the financing of that for financing mega investments. These developments have led to the emergence of a new asset class. It has also drawn a higher level of foreign participation in the Islamic financial markets which has resulted in increased cross-border flows. This has not only contributed to enhancing international financial inter-linkages between economies but it has also contributed towards the more efficient allocation of financial resources across borders.

Islamic finance in 2008 and beyond remains positive despite the current challenging global financial environment. The viability and competitiveness of Islamic finance is derived from several factors. It is from its ability to meet the changing demands of the economy, from its cost competitiveness and from being supported by a well developed legal, regulatory and supervisory framework. But more importantly, are the fundamental Shariah requirements of Islamic finance that support its viability and stability.

Shariah is the key pillar of Islamic finance from which Islamic finance derives its unique characteristics. The Shariah injunctions require that Islamic financial transactions be accompanied by an underlying productive activity. In Islamic finance, there is always a close link between financial and productive flows. Moreover, under the risk sharing principle

required, Islamic financial institutions will share the profit or the loss incurred by the entrepreneur. There is an explicit sharing of risk by the financier and the borrower. This arrangement will thus entail the appropriate due diligence and the integrating of the risks associated with the real investment activity into the financial transaction. In this arrangement, the real activity is expected to generate sufficient wealth to compensate for the risks.

In contrast, conventional instruments generally separate such risks from the underlying assets. As a result, risk management and wealth creation may, at times, move in different or even opposite directions. Conventional financial instruments also allow for the commoditisation of risks. This has led to its proliferation through multiple layers of leveraging and disproportionate distribution, in turn, which could result in higher systemic risks, thus, increasing the potential for instability in the financial system.

In addition, transparency represents a basic tenet underlying all Islamic financial transactions. There is an inherent obligation on Islamic financial services providers to meet the appropriate standards of transparency. It is from the profit-sharing feature of Islamic financial transactions that imposes a high level of disclosure in the financial contract. The accountabilities of the respective parties involved in the transaction are clearly defined in the contract. This transparency also provides a strong incentive for Islamic financial institutions to appropriately manage risks. This disclosure allows the market to assign the appropriate risk premiums to the respective companies and thus the potential for the enhanced role of market discipline to take effect. These inherent features as required by the Shariah injunctions provides inbuilt checks and balances which serves to ensure financial stability in the Islamic financial system.

These features are also reinforced by the development of a comprehensive regulatory and supervisory regime which has been strengthened considerably with the establishment of the Islamic Financial Services Board in 2002. It's establishment has also contributed to the harmonisation in the development of Islamic finance across different jurisdictions. Finally, education institutions have been established to develop the supply of professional talent and expertise in Islamic finance to support the growth and development of Islamic finance going forward.

The evolution of sophisticated Islamic financial products that have been structured based on multiple Islamic concepts have resulted in a new wave of innovation. These products have become competitive and efficient both in terms of product structure and pricing. The more recent innovations include the introduction of Islamic hedge funds and the creation of Islamic benchmark indices. There has also been increased listing of Islamic financial instruments in international exchanges. This has enhanced the depth of the Islamic financial markets has increased its attractiveness of an asset class for investment. This has contributed to increased sophistication of Islamic banking and takaful products evidenced by the recent surge of structured products and investment-linked products.

The sukuk market is fast emerging as the most significant form of Islamic financing and continues to receive strong interest as an avenue for fund raising and investment. The sukuk market has been gaining growth momentum, increasing at an average annual rate of 40 percent. Significantly, 90 percent of the sukuk issuance are corporate issuances. In Malaysia, the issuance of sukuk has surpassed the issuance of conventional bonds for three consecutive years, with the annual turnover in sukuk trading in the secondary market at about RM135 billion. Strong demand for sukuks have also been spurred by the high levels of surplus savings and reserves in Asia and the Middle East.

The sukuk is also an attractive instrument to assist Islamic financial institutions in managing their liquidity requirements. At the same time, it is also an effective instrument used by corporations, institutions and sovereigns in tapping funds at competitive rates to finance long term funding needs. At this juncture, the demand for sukuk is tremendous. The high demand for the sukuk instrument is evidenced by the over subscription which has ranged from two to thirteen times. This has pushed down the cost of issuance by at least 10 to 20 basis points.

This demand has originated from several different parts of the world, both from conventional as well as Islamic financial investors. Due to the scarcity of sukuk issuance, the investors have tended to hold the sukuk for investment thereby reducing the secondary activity in the market. Thus, has resulted in a higher pricing in the sukuk secondary market thereby generating good investment returns for investors. The sukuk thus offers a positive value proposition for both issuers and investors.

Let me turn to Malaysia's experience in Islamic finance. Malaysia has had three decades of experience in which we have developed a comprehensive Islamic financial system that operates in parallel to the conventional system. The supporting legal framework includes a dedicated legislation that takes into account the unique principles of Islamic contracts. The legal infrastructure also includes the court system and arbitration mechanism to resolve disputes to ensure that contracts relating to Islamic financial transactions are effectively enforced. The Islamic financial system is also well supported by a significant number of diverse players in the banking, takaful and capital market.

Finally, for a dual financial system, the tax reforms have been undertaken to accord neutrality in treatment between conventional and Islamic financial products. The establishment of a national central Shariah Council has been important to ensure harmonisation of Shariah decisions in the Islamic financial services industry.

The Islamic financial industry in Malaysia has experienced rapid transformation in recent five years. The product range has now expanded into broad array of innovative instruments. Several new Islamic financial products were introduced which included residential mortgage backed securities, commodity based financing, as well as investment and equity linked product based on musyarakah, mudarabah and ijarah.

The Islamic financial system in Malaysia has evolved as a competitive component of the overall financial system, complementing the conventional financial system as a driver of economic growth and development. Malaysia continues to foster the expansion of the dual banking system where both, the Islamic and conventional systems operate in parallel to deliver innovative and competitive financial products and services. More recently, the increased pace of liberalisation in the Islamic financial services industry has increased foreign presence and participation in our domestic Islamic financial system. This has increase the diversity of players in our system. The Malaysian bond market has also been liberalised to enable foreign entities to raise ringgit and foreign denominated funds in our domestic market. Following these developments we are now entering a new phase in the development of Islamic financial system in Malaysia with the new initiatives to promote Malaysia as an International Islamic Financial Centre. This aims at strengthening our economic and financial inter-linkages and thus promoting greater trade and investment across borders. We are therefore entering a new phase of development for Islamic finance in Malaysia as it becomes more integrated with the international financial system.

Given the surge in demand for Islamic financial products and services, several countries and financial centres are increasingly participating in the industry. The global front-runners will be those with combined strengths of having the capabilities and resources, as well as the ability to secure the confidence of the international Islamic financial community. It is against this backdrop of rising competitive environment that the potential of cumulative bilateral and multilateral strengths will become important in managing the complexities and constraints found in the Islamic financial services industry.

This increasing interest by several financial centres together with their international linkages will contribute towards creating a more integrated international Islamic financial system. Such centres, such as Hong Kong, have the potential infrastructure and the ability to facilitate product offerings that will bridge the regional and international financial linkages. Strategic alliances among Islamic finance players would be a catalyst unleashing the regional and global potential of Islamic finance.

In South East Asia alone there is an immense potential market to be tapped. This market not only comprises the 217 million Muslim population but extends to the non-Muslim community and the foreign national community that operates in the region. The region is increasingly becoming an investment destination, including from the Middle Eastern investors. In 2006, Asia Pacific region has surpassed Europe as second largest region for investment from GCC with USD460 billion investment.

The recent specific initiative to enhance the securitisation market by Cagamas Berhad, the Malaysian Mortgage Corporation and Hong Kong Mortgage Corporation by establishing a joint venture company to provide a mortgage guarantee programme for both Islamic and conventional mortgages in Malaysia is an example of a collaboration. This could be a catalyst for more similar initiatives in the future.

Conventional financial institutions may also enter into alliances with Islamic financial institutions to be co-arrangers, to structure sukuk or other Islamic products based on Shariah compliant assets in this region. The wide ranging availability of such assets and the massive financing needs of the new growth areas in the region such as in China, Indonesia and Vietnam will be attracting funds from surplus economies such as from the Gulf economies. Efforts can also focus on facilitating cross listing of sukuk in multiple jurisdictions. Additionally, the viability of setting up of Asian Sukuk Fund as an extension of Asian Bond Fund can also be explored.

Potential issuers may leverage on Malaysia's sukuk platform and the strengths as the world's largest sukuk issuance centre with over **US\$56b or 62%** of world's sukuk issues. Malaysia has one of the most active primary sukuk market with an average annual growth of 17% during the period 2001-2006. It also has one of the most active secondary market with the turnover of the sukuk trading registered more than USD40 billion annually. International issuers with good rating will benefit from the simplified issuance procedures. This is in addition to the ability to issue multi-currency sukuk and the flexibility to swap RM funding into other currencies to enable foreign issuers to capitalize on the price premium of issuing RM denominated sukuk.

A further area of collaboration is outsourcing, in-sourcing or white labelling. These mechanisms will not only serve as a means to drive down cost of doing business, achieving economies of scale and the avoidance of duplication of resources, but also gives optimum focus by players to develop the newly ventured Islamic finance business. Malaysia's experience in Islamic financial operations and product design can be leveraged upon to systematically structure a complete solution to be offered to other players.

Going forward, Islamic finance as a new industry requires more initiatives to expand the horizon of business parameters and innovative products offerings. There is a need to conduct further in-depth research on Shariah issues relating to risk mitigation, liquidity management and hedging. The combined market knowledge and insights from education and training institutions such as INCEIF, the International Centre for Education in Islamic Finance in Malaysia can make meaningful contributions to the global Islamic finance industry that addressed both market needs and Shariah compliance. In addition, INCEIF's flagship programme, the Chartered Islamic Finance Professional (CIFP) offers the world's first professional certification programme in Islamic finance aims to nurture skilled talent pool for Islamic finance.

Let me conclude my remarks. The global Islamic finance industry has evolved from a faith-based to a business driven industry for all communities. With total global Islamic financial assets amounting to only 40% of the largest conventional bank and with only 300 players compared to 23,000 conventional players globally, competitive pressure moving forward are likely to be intense. But with the underlying strength inherent in Islamic finance and its potential role in bringing together different parts of the world with surplus funds in search of investment opportunities to those with financing requirements accords tremendous opportunities to be drawn from Islamic finance. The combined efforts and collaborative

alliances will pave the way for mutually reinforcing developments that will contribute to the overall international finance system and global economic prosperity.